U.S. ECONOMICS—PROGRESS & CHALLENGES

As January 2, 2013 draws near, the impact of the "fiscal cliff" is attracting more debate and speculation as to how to address this issue. It has become a double-edged sword.

So just what is the "fiscal cliff" anyway?

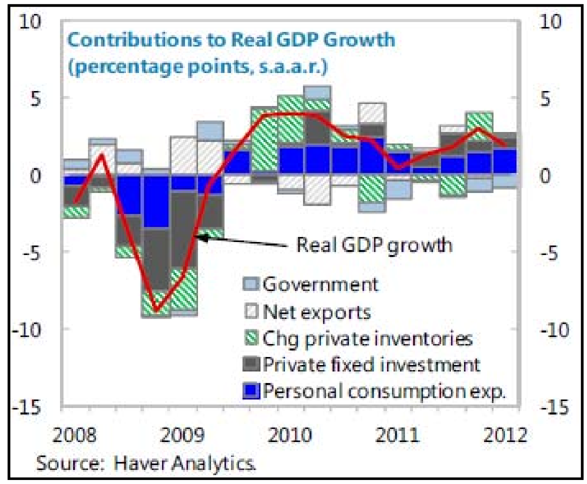
It refers to the expiration of several tax provisions and government expenditures by January 2, 2013. The expiration would trigger tax hikes (the largest increase since WW2) for all working Americans and numerous automatic spending cuts.

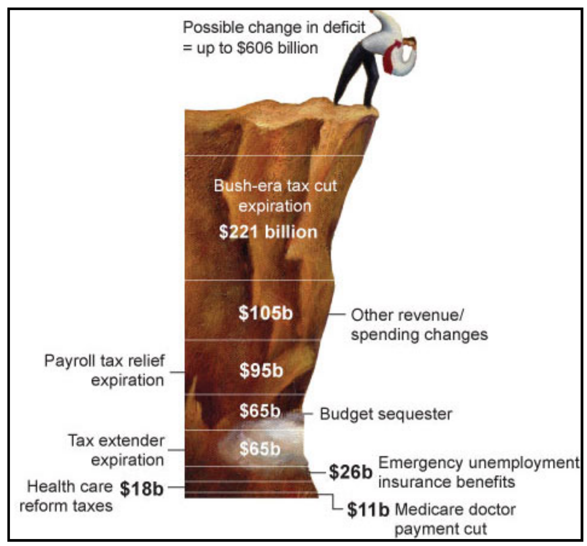
The expiration of these tax provisions and government programs will not only adversely affect consumer spending (as well as consumer confidence), it will hinder several companies that rely on government contracts, most notably those in the defense sector.

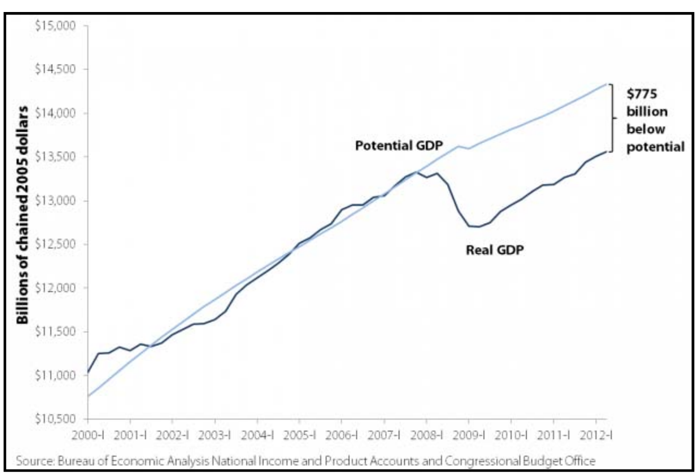
While the expiration of certain tax provisions is a positive for addressing the fiscal deficit, some feel that these cuts will hurt the economy. In fact, many economists expect the U.S. to enter a recession if these tax hikes are made effective. This is a gross exaggeration.

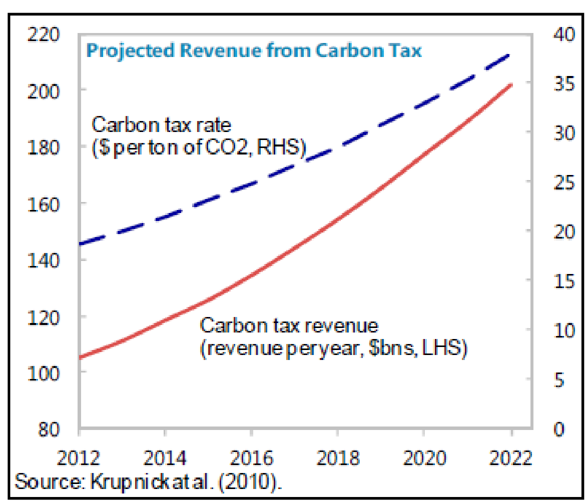
The fact is that the U.S. remains in the recession that began in December 2007. However, the economy has been weakening since the summer of 2011 because of the depletion of stimulus funds from the ARRA passed in February 2009.

The real issue here is when and how Washington will address the medium- and long-term budgetary issues. At some point, these issues must be dealt with in order to reduce the debt to a sustainable level. The longer they delay, the more dire the situation will become.









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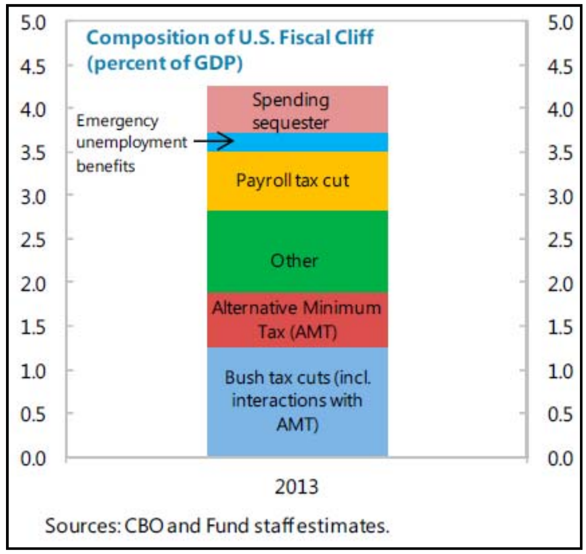
If Washington does not allow the tax cuts and other programs to expire at the deadline, when exactly do they expect to address the fiscal issues?

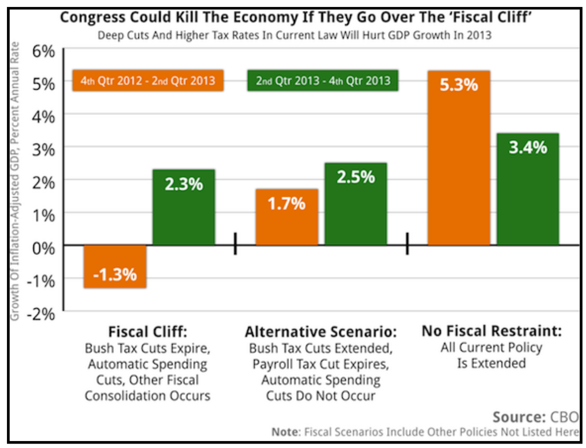
Of course, the media continues to side with supply-side economists who have even warned that a “depression-like” scenario would result upon expiration of these subsidies. This is laughable. The fact is that several adjustments must be made if the U.S. expects to get its long-term fiscal house in order. The longer these adjustments are delayed the worse off the U.S. economy will get. It is best to make these adjustments now, while there is no crisis.

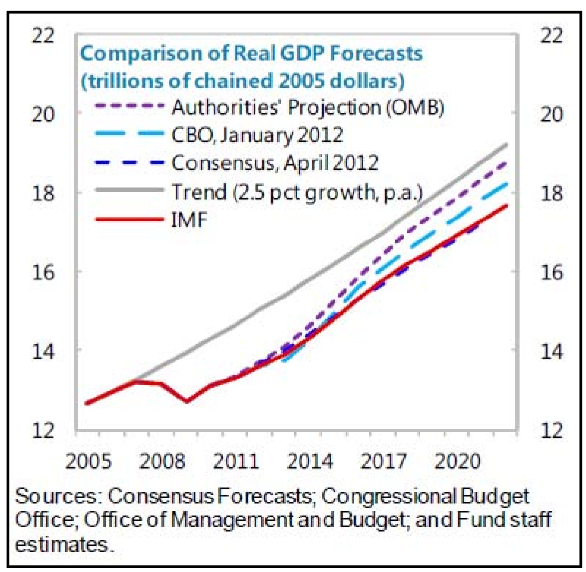
The final chart shows real GDP forecasts for the U.S. through 2020. The grey line shows the extrapolated trend of GDP growth based on historical data. As we have discussed in prior issues, GDP growth cannot possibly reestablish its previous trend before 2020, due to the permanent damage created to the economy by the financial crisis.

Surprisingly, the IMF’s forecasts appear to be fairly close to our own (for once). Maybe this is an indicator that our forecasts will turn out to be wrong!

You should note that it is of no coincidence that the OMB estimates are the most optimistic since the OMB is comprised of economists who work for the current administration. While the CBO is supposed to be non-partisan, their optimistic projections serve the main role as cheerleader.







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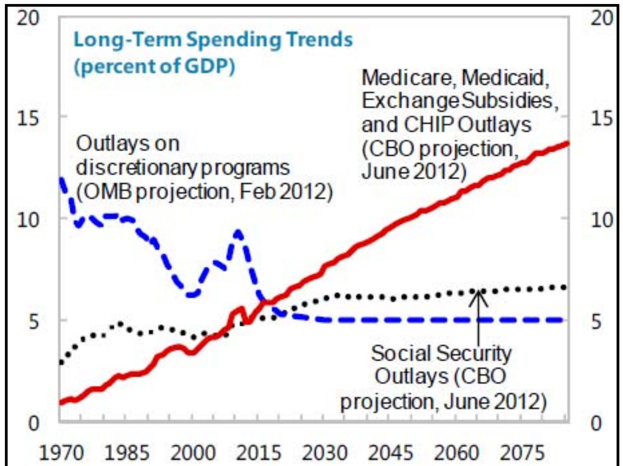
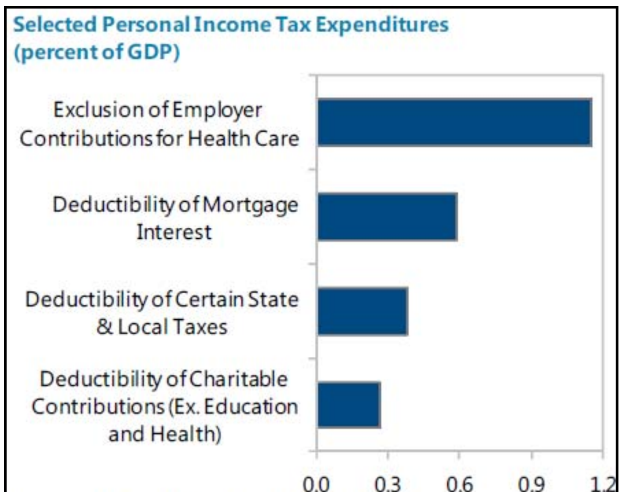
As part of their challenge to form and execute a plan of prudent fiscal consolidation, Washington is debating where to cut the budget. Of course, you are not likely to hear mention of defense spending as a candidate of significant cuts. By now, you should understand why.

Note in the second chart that deductibility of mortgage interest is second only to exclusion of employer contributions for health insurance in terms of personal income tax expenditures. In other words, these programs cost the federal government lost tax revenues.

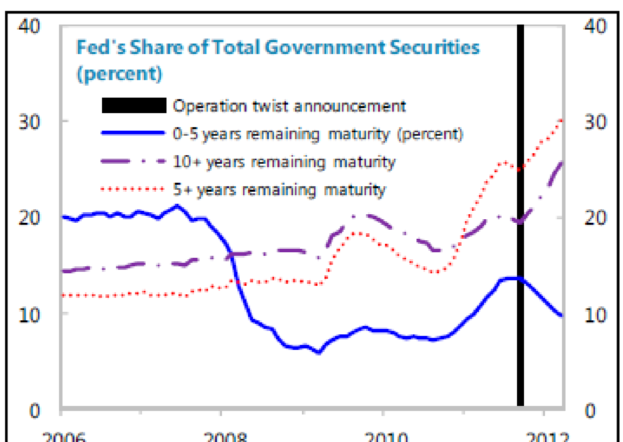
Later when we discuss possible sources of tax revenues, we will show that the total value of personal tax expenditures from housing exceeds that of employer contributions for health insurance once the impact of imputed rents and capital gains are added (see Taxation, p. 34).



Sources: Congressional Budget Office and Fund staff estimates.
Note: Outlays for Medicare are on the net basis including offsetting receipts.



Source: Office of Management and Budget.



Source: Haver Analytics.

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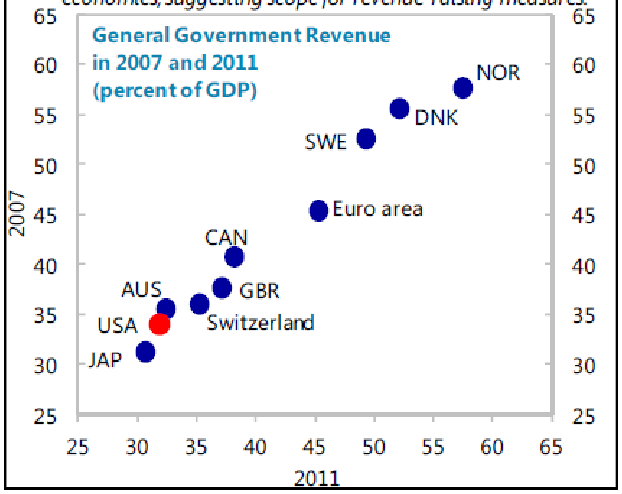
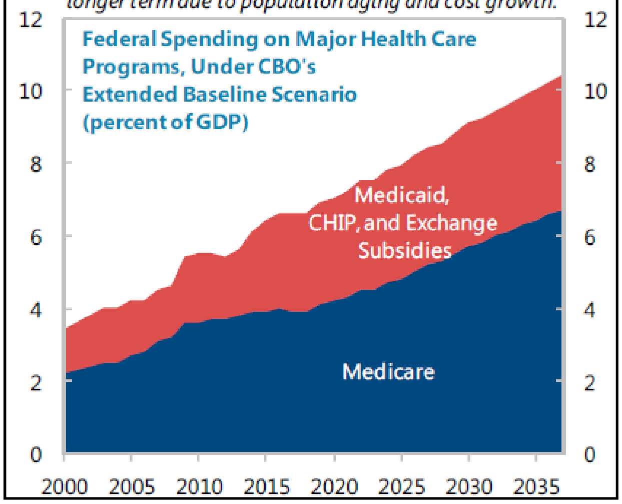
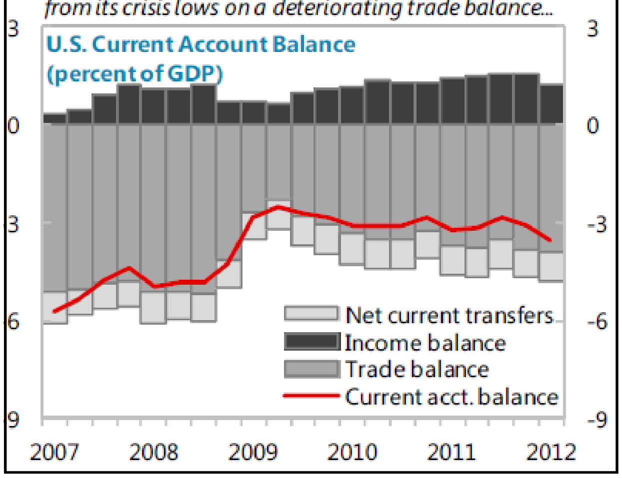
The revenue ratio is lower than most other advanced economies, suggesting scope for revenue-raising measures.



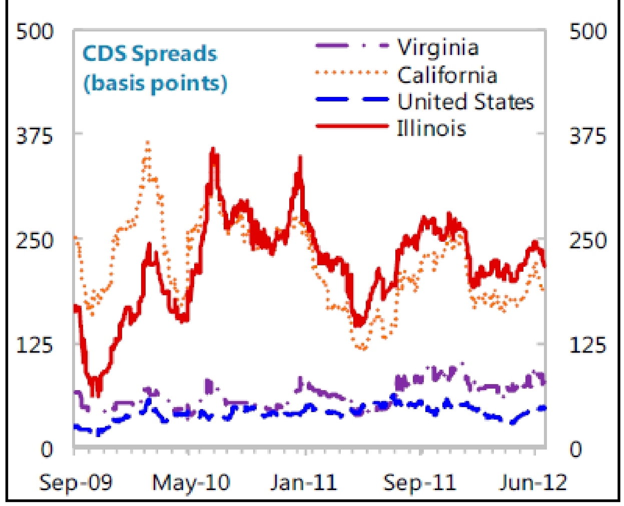
... health care will remain the key budget threat in the longer term due to population aging and cost growth.



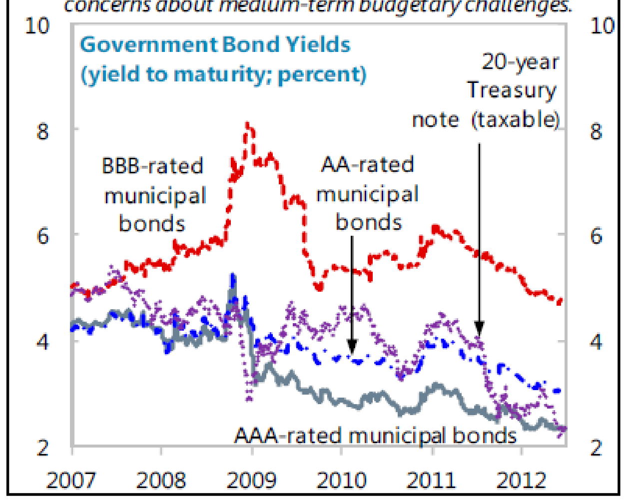
The U.S. current account deficit has widened slightly from its crisis lows on a deteriorating trade balance...



The CDS spreads for lower-quality issuers remain elevated, but are below their 2010 peaks.



Funding costs have generally declined, but the spreads over Treasuries fluctuate with general risk aversion and concerns about medium-term budgetary challenges.



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In the May/June 2012 Global Economic Analysis, we reviewed the financial status of state and local governments, dating back to the devastation from the financial crisis in 2008, to the progress made since then.

As you will recall, we stated that, although state tax revenue (all fees and assessments) mounted a spectacular recovery in 2010 (lasting through mid-2011), this relative progress was due primarily to the funds supplied by the stimulus package (ARRA).

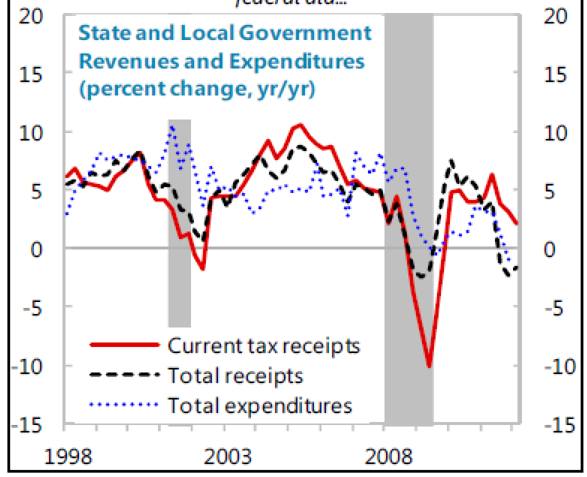
Ever since the economic stimulus ran out, state tax revenues have been trending downward (since approximately Q2 2011). They are now approaching a worrisome level.

Property tax revenues also mounted a spectacular recovery due largely to the economic stimulus package. This recovery was especially dramatic considering very little improvements in the housing market. But as you can see, property tax collections are now beginning to trend downward.

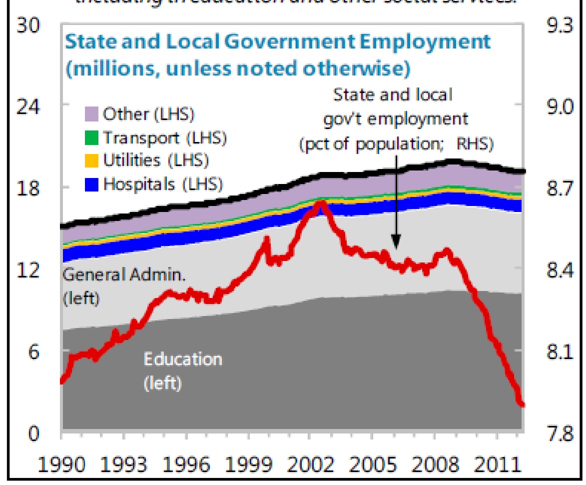
In contrast, **local taxes have made no progress since the financial crisis. In fact, the situation is worse today.** This is an especially worrisome trend especially given that the economy is guaranteed to weaken through at least the summer.

This trend is consistent with our previous assessment of the high chance of several government defaults on the local level, as opposed to massive defaults on the state level predicted by others.

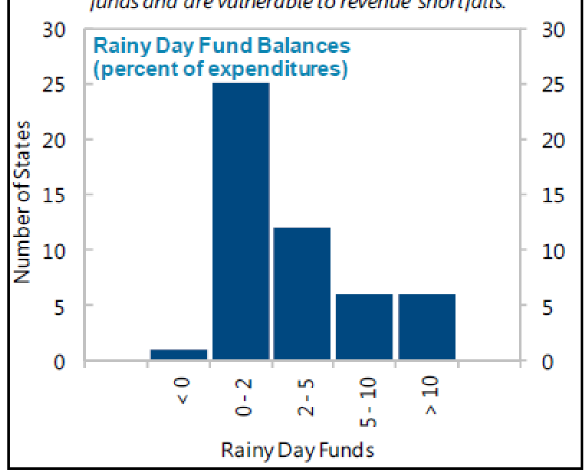
Tax collections are gradually recovering, but the SLGs have grappled with the phase-out of federal aid...



... and continue to downsize their activities, including in education and other social services.



Many states have depleted reserve "rainy-day" funds and are vulnerable to revenue shortfalls.



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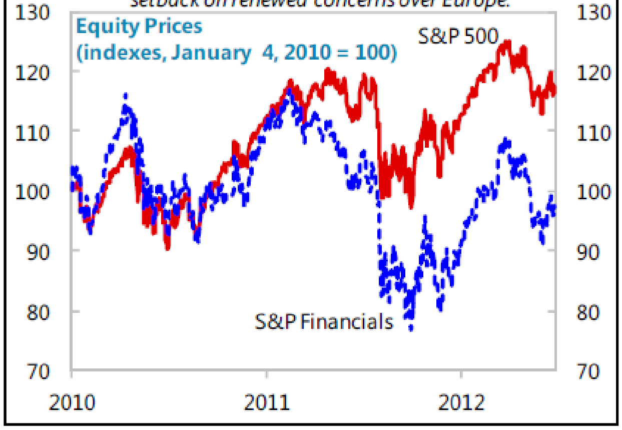
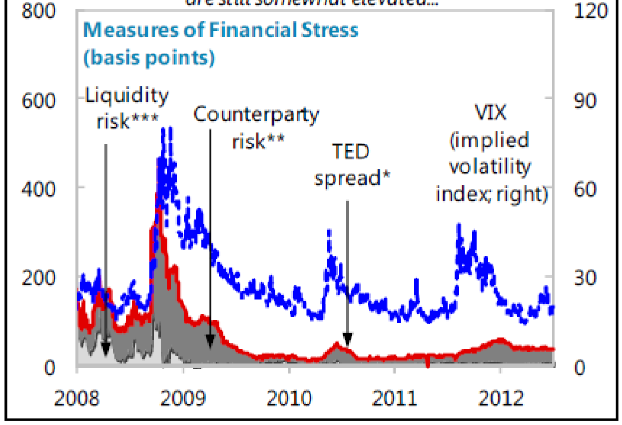
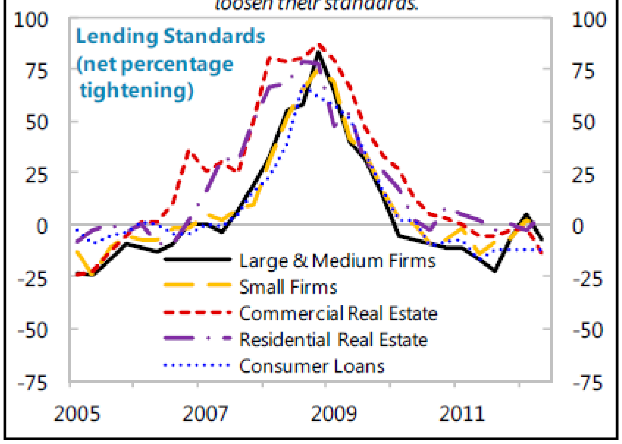
Equities are up relative to last fall, even with a recent setback on renewed concerns over Europe.



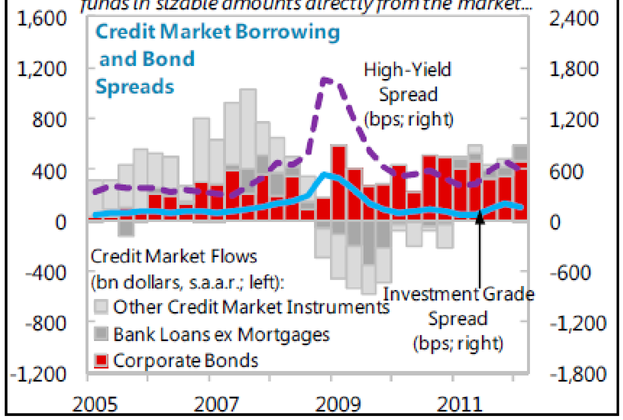
In fact, some measures of financial stress are still somewhat elevated...



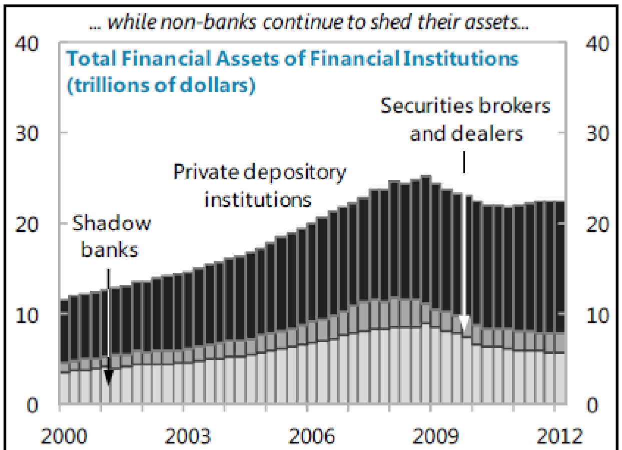
... while banks appear to remain reluctant to further loosen their standards.



Instead of bank lending, corporations continue to raise funds in sizable amounts directly from the market...



... while non-banks continue to shed their assets...



Sources: Board of Governors of the Federal Reserve System

... with securitization activity remaining very depressed.